ORIGINAL

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WEST WATER AND WASTEWATER DISTRICTS.

Docket No. WS-01303A-02-0867

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WATER AND WASTEWATER DISTRICTS.

Docket No. WS-01303A-02-0868

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER DISTRICT AND ITS HAVASU WATER DISTRICT.

Docket No. WS-01303A-02-0869

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS AGUA FRIA WATER DISTRICT AND ITS ANTHEM / AGUA FRIA WASTEWATER DISTRICT.	Docket No. WS-01303A-02-0870
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS TUBAC WATER DISTRICT.	Docket No. W-01303A-02-0908

NOTICE OF FILING
SURREBUTTAL TESTIMONY of

Frank J. Grimmelmann

Anthem Resident &

Chairman Finance Committee, Anthem Country Club Homeowners Association, Inc.

Q. Please state your name and present position for the record.

A. My name is Frank J. Grimmelmann. My business address is 42441 N. Cross Timbers Court, Anthem, AZ 85086. My telephone number is (623) 551-1526. I am a resident of Anthem, Arizona, Chair the Finance Committee for the Anthem Country Club Homeowners Association, Inc., and through the Finance Committee serve as a unpaid advisor to the Community Council Liaison Committee which represents the entire community on matters regarding Arizona American Water Company's ("AZAWC") proposed rate increase.

Q. Please state your present occupation for the record.

A. I am the Founder & Board Member of UltraBridge, Inc., a company that provides full information technology and back room business process outsourcing for post acute care health organization chains that range from Skilled Nursing Facilities to Home Health Agencies and Community Based Organizations. With a business model that focuses on driving quality of care, profitability and top line growth, we presently serve customers in over 30 states, having began operations 5 years ago this coming February. Officially, I'm an employee of F.J. Grimmelmann & Associates, Inc. ("FJG&A"), a company founded 22 years ago that offers capital, consulting and operations management support for companies that range from start ups to those more established companies positioned to and wishing to maximize their market position and investor value. FJG&A serves as an advisor to UltraBridge. All of these companies operate under the umbrella of TGG Holdings, essentially my personal investment and management organization.

Q. Please state your educational qualifications and relevant experience for testifying with regard to the AZAWC application for an increase in rates.

A. Educationally, I hold a Masters Degree in Business Administration from the University of California at Berkeley in International Business and Finance, and a Bachelor of Arts

Degree in Operations Management with a concentration in Business Law from the University of South Florida in Tampa. Historically, I have senior management and consulting experience in operational financial management, technology and the capital markets, having served as the Chief Executive Officer, Chief Financial Officer, and Chief Information Officer of health care organizations ranging from start ups to established health care systems with annual revenues of $1.3 Billion. I have also served as the national manager and senior vice president for health care investment banking for Shearson American Express and Paine Webber, Jackson & Curtis. I have contributed to two books on short term investment strategies and returns, and have developed numerous capital market financial solutions in strategic partnerships with both Citibank and Goldman Sachs. I have also served as an expert witness on the capital markets with regard to health care regulatory agencies. Finally, I have served as the CEO of start up and emerging organizations, positioning them to maximize there position in the markets.

Q. On whose behalf are you testifying in this proceeding.

A. On behalf of myself, as a resident who is affected by the outcome in this proceeding, and the interests of the Anthem Community as the Chairman of the Anthem Country Club Homeowners Association Finance Committee, in my capacity as an Intervenor in this proceeding.

Q. What is the purpose of your rebuttal testimony in this proceeding?

A. My testimony is being filed in response to and support of the direct testimony of Staff and RUCO, and also in response to the direct and rebuttal testimony of AZAWC and the rebuttal testimony of others in support of AZAWC. I will generally be covering issues related to: 1) The rate increase proposed by AZAWC for the Anthem Water and the Anthem Waste Water rates and Staff/RUCO's recommendations with regard to these rates, 2) A high level review of the appropriateness of Staff and RUCO proposed adjustments related to AZAWC's proposed rate increase, and 3) Factors to be considered in setting the appropriate AZAWC equity rate of return.

Q. What are your observations with regard to the rate increase proposed by AZAWC for the Anthem Water and the Anthem Waste Water rates and Staff/RUCO's recommendations with regard to these rates?

A. As a community Anthem presently pays a high rate relative to other water systems for services due to the unique nature and high quality of our 'state of the art' water infrastructure. We can summarize our communities feelings about this with the following points: 1) Under the present Commission rate setting methodology, there are legitimate differences in the cost of water at Anthem and other communities since ground water is not used due to all water being pumped from CAP though a state of the art water treatment system, and the higher costs associated with meeting current code and more recent construction. 2) The proposed 32.45% increase for combined Anthem Water and Waste Water (during a period of 11.9% inflation) over an existing base water rate that is already the highest rate in the area, and roughly 123% higher than the average of the other AZ AZWAC water & sewer rates (excluding Anthem), appears inequitable and inappropriate just from a standpoint of reason. 3) RUCO, which is charged with advocating for consumers in the case of any proposed water utility rate increase, and Staff are the appropriate bodies to review the highly complex application for a rate increase, 4) Both Staff and RUCO appear to have given particular and appropriate focus to the proposed Anthem increases, having undertaken a thorough audit to review among other issues the capacity, capital and cost allocations that were used to establish the initial base rates, and appropriate present rates under the State's rate setting methodology. 5) Today's rates, the proposed AZAWC rate increase, and the proposed reductions of Staff and RUCO on the average customer's monthly bill are summarized in the following table:

Average Residential Customer's Monthly Bill Under Various Approved Rates

	Today	AZAWC		ACC STAFF		RUCO	
Water	$ 31.32	$36.62	16.9%	$19.92	-36.4%	$24.49	-21.8%
Sewer	$ 30.00	$45.45	51.5%	$ 27.53	-8.23%	$35.86	19.53%
	$ 61.32	$82.07	33.8%	$47.45	(13.9%)	$60.35	(1.6%)

Above chart represents the Average Customer's Monthly Charges for a ¾" meter (most common meter size for residential customers in Anthem). Actual Customer's bill may vary according to the amount of water consumed and you can get an estimate of your actual bill by multiplying the percentage increase for the water and sewer rate times those components on your actual bill.

7) If the AZAWC rate increase is granted, it rewards the inaccurate (or potentially incompetent) initial rate estimates requested by the former Citizens Water Company, and the acceptance of these rates by AZAWC at the time of acquisition from Citizen's Water Company based on Staff and RUCO's application of the rate formulas applicable for AZ Utility rate setting. 8) We conclude that the Commissioners should either accept Staff and RUCO's recommendation to deny the rate increase on the basis of the quality of the submission, or to support Staff and/or RUCO's recommendations for an appropriate rate level based on the application and supporting evidence submitted by AZAWC.

Q. Why do you feel that Staff's and RUCO's recommendations should be supported by the Commission with regard to Staff and RUCO's suggested adjustments?

A. Rather than comment on each of the 10 or more adjustments that Staff made to AZAWC's rate application, I will instead focus my comments on three general areas that seem to account for and summarize the major adjustments at a high level that result in the recommendations for average decrease in the overall bill of the Anthem residents: 1) AZAWC duplicated its recovery for inflation by requesting the application of RCND valuation of the assets and depreciation against this base, versus historical cost of the assets, while simultaneously requesting a return on equity that implicitly provides for inflation under the AZ rate setting methodology, 2) AZAWC proposed to recover its acquisition premium paid for the Citizen's Water Company at the time of acquisition, and 3) AZAWC used estimated costs in its application when lower actual cost were available & inconsistently mixed its own cost basis and Citizen's cost basis to support its position based on the detailed audit of Staff and RUCO. While the remaining adjustments also impact the rate, these are the specific items that I will focus on.

Q. Please expand on your comment with regard to the proper methodology for permitting the recapture of inflation being double counted in the application?

A. Let me provide an example. Assume that you have a brand new water system's fixed assets valued at $100 as its total cost of construction and that this amount reflects all of the assets on the Balance Sheet. Essentially, for purposes of comparison, let's assume for simplicity that the inflation rate is 7.9%, and that we wish to replace the asset after 10 years. We assume 7.9% compounded annually for purposes of illustration only since the value of $1 at the end of 10 years will double, i.e. $1 of assets is now nominally equal to $2. Essentially, the replacement cost for the same physical building and equipment in our example which cost $100 at the time that it was placed in service, now has a nominal value of $200 (or costs $200 to replace) 10 years later given our assumed annual inflation rate of 7.9%, i.e., the same physical asset costs twice as much. Therefore, assuming presently that the building is totally financed by equity, the utility would need to have an annual rate of return equal to the rate of inflation on its equity to replace the assets at there replacement cost.

In Summary, assuming that the acceptable rate of return on equity provides for inflation in its calculation and is in turn applied to the historical value of the AZAWC's assets at the time that Citizen's built them, there is no need to adopt the RCND methodology which also accounts for inflation in restating the value of the assets presently. Doing so inherently results in duplicating the recovery for inflation and amounts to a double dip.

Q. Are you suggesting that AZAWC should receive a 7.9% return simply for the recovery of inflation before taking into account other factors?

A. Absolutely not. I am suggesting that the recommendation to make an adjustment to the application to deny the application of the RCND methodology be supported by the commission since doing otherwise would double count inflation as RUCO suggests just through mathematical logic. The actual rate of inflation utilizing the CPI, or the GNP Deflator for the 2002 year is somewhere at or below 2%. Alternatively, the Handy Whitman Index, a privately prepared proprietary index applied by some Utility rate setting agencies could be used and should yield comparable results. However, some rate setting bodies, such as the Minnesota Public Utilities Commission, have not accepted the traditionally used Handy Whitman Index since it is a proprietary formula and not generally obtainable or widely published for easy access. Therefore, the return for inflation is 2% or less presently and is implicitly included in the acceptable rate of return on equity which I will discuss separately in my subsequent testimony.

Q. Why do you feel that AZAWC should not be allowed to recover the premium paid to Citizen's Water Company in the purchase price that it paid to acquire the company's assets, and that this proposed adjustment should also be supported by the Commission?

A. Logically, if an inflated price could be passed on to residents in a rate increase every time that a company is acquired, it would perpetuate inefficiencies and encourage unnecessary and inadvisable acquisitions that are not in the public's interest. If the Commission approved the recovery of this premium, possibly I might just buy the assets from AZAWC at twice the purchase price they paid to Citizen's, and simply ask that the rates be increased further so that I can recover this premium. Seriously, this is a basic premise of accounting and economics that is fairly obvious. Clearly, the Commission should support the recommendation for this adjustment, denying the rate increase associated with it.

Q. Turning to another point, why do you support Staff and RUCO's contention that there should be an adjustment to reflect a consistent approved basis for calculating costs?

A. If actual costs are available and consistent with the approved methodology for Arizona rate setting, why would you mix and use estimated costs. Likewise, is it logical to mix the cost basis of AZAWC and Citizen's in establishing the basis for cost in the rate setting process when actual numbers are now available consistent with the AZ rate setting methodology, and the correct basis with these numbers available should be the costs of AZAWC to deliver water. In short, applying this adjustment is logical and straightforward, and should be supported by the Commission.

Q. What is your position with regard to the difference that exists between Staff's and RUCO's recommendations on the appropriate return on equity for AZAWC once the cost basis is agreed upon under the AZ rate setting methodology?

A. Rather than comment on a specific rate of return on equity, since I am testifying as a 'real world practitioner' and not an expert witness in Utility rate setting, I prefer to address this from a practical philosophical foundation. This testimony will build upon my prior comments on inflation, and arrive at some real world observations that the Commission can consider in its deliberations on the appropriate rate of return on equity.

Before proceeding with this analysis, I would like to make the practical observation that the Capital Asset Pricing Model ("CAPM") is the underlying foundation for all modern capital theory, and the practical operation of our capital markets. It would be irresponsible to base the rate of return on a business strategy adopted by any firm, even if that firm happens to be Citibank, a company that I have strategically partnered with in the past. CAPM is a logical and appropriate foundation for the rate setting mechanism in Arizona and fortunately this is recognized by Staff and RUCO.

Staff and RUCO each employ methodologies to arrive at an adequate rate of return under rate setting mechanisms in the State of Arizona that are substantially less than that requested by AZAWC and other 'experts' that support their position. It is obvious that the rate of return on equity must provide a return that allows a utility to competitively attract public capital in the markets, and to compete with peers demonstrating good management. However, given the unique monopoly position of a utility, providing an excess margin which would inappropriately position AZAWC to be more profitable than its peers shouldn't inappropriately be permitted at the expense of consumers. Generally, the rate of return of any utility is lower than businesses that are in a more completive market due to the fact that the utility is in a monopoly position. Specifically, since consumers must pay the rate set by the Commission or risk having their water shut off, the utility is in a unique position to collect monies from the residents they serve as a pass-through to their investors who benefit from either dividends or capital gains on sale. Since utilities enjoy a diversified broad base of consumers who purchase their product, needless to say they benefit from lower volatility and risk than the average company in a competitive market environment. This accounts for their low 'beta factor' or minimal risk against correlation of movements in the general market.

Therefore one would expect their risk adjusted rate of return to be lower to attract investors with an appetite for less volatile securities.

Q. Given this assessment, what is the appropriate theoretical rate of return?

A. This is developed and defined by CAPM in determining both the theoretical and practical rate of return that a company should earn. Again, let's turn to the model that we previously discussed during my earlier comments on inflation, and expand the balance sheet to include current assets, liabilities and equity, in addition to the fixed assets in a simple example.

Simplifying assumptions, let's build on our previous example by assuming the following: 1) liquid current assets are two times the level of current liabilities (cash and accounts receivable are essentially twice the amount of current trade credit and other liabilities as a measure of liquidity), 2) The long term debt to asset ratio is 66 2/3% (essentially, each $1 of assets purchased is financed by .667 cents of debt and .333 cents of equity to avoid excessive leverage in the financial structure), and 3) that 20% of the total assets are current assets (cash and other liquid assets) with the remaining assets (building and equipment), 4) that we still have $100 of total assets, 5) that our simplifying assumption for inflation remains at 7.9% (so that at the end of 10 years our same physical assets will nominally double in value), and 6) that fixed assets will be replaced annually as they depreciate, i.e. the annual depreciation is immediately reinvested into fixed assets so that no funded depreciation reserves are necessary. Given these assumptions, let's see what happens to our balance sheet over a ten year period. First, the physical assets (cash, receivables, building and equipment) will nominally double in value, so that the equivalent assets required to do the job that cost $100 at the outset will nominally appear as $200 in our balance sheet at the end of year 10, i.e. $1 equals $2 when compounded annually at 7.9% over a 10 year period. The relationship of Current and Fixed assets are assumed to remain proportional, so our initial $20 in current assets will grow to $40, and our $80 in fixed assets will grow to $160 at the end of ten years, respectively (simply stated the inflation proportionately affects each asset class equally). Therefore, at the end of 10 years, we have $200 in assets, comprised of $40 in liquid current assets and $160 in fixed assets.

Q. So given the doubling of the Assets over the 10 year period, what happens to the liabilities and equity side of the balance sheet required to finance inflation alone, recognizing that the basic accounting definition requires that Assets must equal liabilities + equity at all times?

The answer to this depends on the rate of return being earned on equity after paying the interest on the debt. To make this point, let's first examine what happens when the company earns no net income at all over the period. Essentially, assuming that the company continues to have access to the capital markets and trade credit, at the end of ten years the relationship of current assets to current liabilities (Current ratio is 2 times multiple or $20/$10 in time period zero) would remain proportional and the balance sheet would have $40 in current assets supported by $20 in current liabilities at the end of the period given our simplifying assumptions. In turn, what happens to the long term debt and equity required to finance the remaining $160 in assets ($200 in assets less $40 financed by current liabilities <essentially trade credit>)? Since equity will remain constant at $33.33 (1/3 equity), then the remainder of the required financing would have to be provided by long term debt of $146.67 ($200 assets - $20 current liabilities - $33.33 equity = $146.67 required long term debt). This holds true because the only thing that will increase the equity, other than the sale of new stock, is net income. Also, since we assumed to be at accounting breakeven, there were also no losses that reduce equity.

Q. So what income would be required to achieve 'economic breakeven', which we'll define as the return necessary to maintain a stable relationship between the liability and equity components of the balance sheet?

A. The point again is that the rate of return must at the threshold at least equal the rate of inflation to achieve "economic break even', or equilibrium between debt and equity in the financial structure. Stating this differently, an annual rate of return on equity of 7.9% in our example would permit the company to double its equity, thereby maintaining the same proportion of long term debt in its financial structure. In short, the long term debt to asset ratio at the outset and at the end of the 10 year period would remain at 66.667%, creating equilibrium for optimal access to the capital markets.

Q. How does this apply to the AZAWC rate application given that you have stated that the current rate of inflation in the current economic environment in 2002 is approximately 2% or less?

A. Applying this example to our present 'real world' situation, the threshold rate of return on equity to cover inflation is at or below 2%. If this was the allowed rate of return on equity in the present economic environment, AZAWC would be earning a sufficient rate of return to replace its physical plant. However, in practice investors demand a higher rate of return to compensate them for business, political and governmental uncertainty, and other risks associated with investment in a water utility company or a specific investment in AZAWC, including a necessary return to support research and development. Given the present low rate of inflation, the total required rate of return on equity will not be as high today as during a historical high inflationary period. As such, AZAWC and other supporters who base the required rate of return on a market environment that is more inflationary in comparative rates that are employed for analysis artificially distort the required return.

At the same time, Staff in applying CAPM consistently provides the foundation for a realistic and pragmatic rate of return required to satisfy the capital markets during the current low inflationary period as defined by the capital market itself. As such, my conclusion is that Staff's and RUCO's recommended rates of return are more in line with the theoretical and practical maxims required by investors in the present market environment.

Q. Do you have any other points to make in support of the recommendations of Staff and RUCO to assist the Commission in its deliberations?

A. Yes, Anthem is a diverse and growing community that consists of families ranging from those just starting out to those on a fixed income, with everything in between. We are also a community that recognizes the cost of quality and the need for AZAWC to earn a fair return dictated by the Arizona rate setting methodologies upon which the present system is based. We don't mind paying our fair share, but feel it would be a travesty to permit AZAWC to enjoy a windfall that is unsupportable by acceptable rate setting methodologies employed in Arizona. Further, we are appalled by Staff's and RUCO's independent assessments of the poor quality of AZAWC's submission, which places a greater burden on Staff and RUCO to undertake an analysis, and in turn, a greater burden on the rate payers to pay the cost of this inappropriate and unwarranted effort of Staff resulting directly from the poor quality of the submission. Based on this, we ask the Commission to give serious consideration to the Staff and RUCO recommendations in your consideration of the AZWAC rate request, and based on this to either deny the request or consider the Staff and RUCO recommendations which would result in an overall decrease to our present average monthly bills in Anthem for Water and Waste Water services.

Q. Do you have any further closing observations?

A. Yes based on the detailed audit of Staff and RUCO undertaken in the course of their analysis, I would like to recognize and commend the developer, Del Webb/Pulte for being a responsible citizen and meeting its commitment to the residents of Anthem. The analysis appears to support that the developer appropriately transferred the assets required to meet the capacity needs of Anthem to the Citizen's Water Company at a fair market price, and stepped up to meet their obligation to subsidize or underwrite the remaining excess capacity, due to a down sizing of the planned units in Anthem, by contributing equity to the project to absorb what otherwise would have been excess costs born by the Anthem residents. This deserves to be noted for the record.

Q. Does this conclude your rebuttal testimony?

A. Yes.

RESPECTFULLY SUBMITTED this 30th day of October, 2003.

Frank J. Grimmelmann
Anthem Resident
Chairman, Anthem Country Club
Homeowners Association, Inc.
Finance Committee

AN ORIGINAL AND TWENTY-ONE COPIES of the foregoing filed this 30th day of October 2003 with:

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